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Egypt: Economic Impact of the 1973 War and Its Aftermath

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Egypt: Economic Impact of the 1973 War and Its Aftermath

Egypt has emerged from the October war and its aftermath with its physical assets largely undamaged and its economic prospects greatly improved. Prior to the war, Egypt was faced with difficult economic circumstances as a result of declining Arab aid and worsening terms of trade. Thanks in large measure to wartime contributions from other Arab states, Egypt now has financial resources sufficient to reverse the pre-war economic downturn and, once post-war distributional problems are resolved, to sustain some growth in output for almost two years.

Failure to achieve a general settlement could create tensions that would severely hamper Egypt's prospects for sustained long-term growth. On the other hand, a prompt settlement resulting in the return of Sinai and a permanent end of hostilities would place Egypt's ambitious economic goals within reach.

Disengagement and settlement also could free Egypt from the heavy dependence on bilateral aid and trade that has prevailed for a decade. With tensions in the area reduced, multilateral Arab aid and private Arab and Western investment could replace bilateral governmental loans and grants which have so constrained Egypt's freedom of maneuver. Military dependence on the USSR could be sharply reduced. In addition, with greater prosperity assured, Egypt could afford to reorient its export trade and industries toward Western markets.

Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] of the Office of Economic Research, Code 143, Extension

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DISCUSSION

The Impact of the War

1. In sharp contrast to the 1967 conflict, the October war left Egypt's economic assets almost untouched. During the inter-war period, Egypt had evacuated most of the population and all of the undamaged movable physical assets from the Suez Canal area, leaving a broad economic "no man's land" adjacent to the war zone. This area bore the brunt of Israeli air and artillery attacks and was partly occupied by Israeli forces. The interior of Egypt, vulnerable to Israeli "deep penetration raids" in 1967 and later during the 1970 war of attrition, was protected during the October war.

2. A shortage of petroleum products has been the most serious result of the war. The shortage developed when the Gulf of Suez oilfields were shut down and Israeli occupation of the Suez city area interdicted transport routes and thus deprived Egyptian refineries at Tanta and Mustorod of crude oil. The Egyptians thus have been forced to import extra petroleum products through the port of Alexandria. Increased Soviet deliveries to Alexandria have filled a part of the gap. Other Arab countries have sought to buy products for Egypt, but supplies have been tight.

3. The general supply situation during the war was no worse than during pre-war months, and wartime euphoria increased Egyptian tolerance of inconvenience. Few items except medicines and petroleum products were unusually scarce. Essential items such as wheat had been stockpiled. Before the war, some rationing had been dictated by cuts in imports because of foreign exchange shortage. After the war began, only fuels were added to the pre-war rationing list.

4. Egypt mobilized only a few reserve units, leaving the civilian labor force largely intact. Over the years the government has built up a standing army of 250,000, using military recruitment as a means of employing a portion of the labor force which would be unable to find civilian jobs. Casualties from the fighting will have little impact on the civilian labor force. The dead and wounded constitute a minuscule fraction of the labor force and most were professional soldiers without peacetime economic functions.

5. The war probably did not increase national military outlays to any great extent, although data on actual defense expenditures during the last several years are not available. Expenditures on maintenance of forces would not have increased substantially, and replacements for equipment

losses (valued at about US $500 million) and expended supplies either were provided on liberal terms by the USSR or paid for outright by other Arab states. During the hostilities, Saudi Arabia, the Gulf Emirates, and Libya acted as purchasing agents for medicines, tires, and other war-related purchases. Libya reportedly served as a major logistics center, ordering and transshipping military supplies. Evidence suggests that these states, rather than Egypt, paid for most of the goods procured.

6. Egypt's chronic distribution difficulties were worsened by the war, in particular by the three-weeks' closure of Alexandria, Egypt's principal port. Since it reopened, shipments of delayed exports and inbound petroleum products have added to the confusion at the normally congested port. Port congestion has led to periodic shortages of imported industrial inputs and concomitant delays in implementing development projects. Distribution problems will continue to handicap economic recovery.

7. The war has caused some temporary losses in Egypt's foreign earnings, all of which have been more than replaced by the wartime contributions of the oil-rich states. Shutdown of oil production in the Gulf during the final quarter of 1973 has cost Egypt some $15 million in lost earnings from crude exports and about $2 million for products imported to replace those formerly refined from Suez crude. Forgone earnings from oil exports will be considerably greater at today's prices and will continue until the oilfields are reopened. Tourist revenues earned Egypt $100 million in foreign exchange in 1972 and since October have been reduced to a trickle. Based on the 1967 war experience, earnings from tourism for 1974 could be reduced to about $55 million. The recent disengagement, however, may induce a more rapid return to normal than occurred after the 1967 war.

8. These losses will be offset partly by savings in imports. Cairo was able to impose far more stringent austerity measures because of hostilities than would have been possible under the earlier no-war, no-peace stituation. According to Cairo, this produced a $100 million reduction in the 1973 import bill. Expenditures for consumer goods imports, including food, have been further reduced by using reserve stocks and by the receipt of relief supplies contributed by foreign donors. Industrial inputs also have been donated, including some 800,000 metric tons of oil supplied by Saudi Arabia and Libya.

9. Although the net impact of these added foreign exchange costs and savings is negative, the increase in the current account deficit is small. Moreover, it is swamped by large infusions of wartime Arab aid. During the course of hostilities, almost $1 billion in non-military aid was pledged by Arab states, of which $500 million almost certainly has been transferred

to Egypt (see Table 1). This sum, in addition to a pre-war Saudi transfer of $300 million to $500 million brings extraordinary receipts in the last half of 1973 to a minimum of $800 million. Of this amount, only about $20 million will be needed to offset net war losses which must be borne by Egypt. The balance presumably can be spent for other purposes or left to accrue, temporarily, as reserves (see Table 2).

Table 1

Egypt: Wartime[1] Non-Military Aid

	Million US $
Total	556
Donations of goods	20
Oil	4
Food	16
Cash transfers	536
Saudi Arabia	200
Libya	136
Abu Dhabi	100
Kuwait	100

1. Fourth quarter of 1973.

Table 2

Egypt: Estimated Impact of the War on Balance of Payments

Million US $

	1973	1974	1975
Adjusted current account balance estimate	-325	-615	-455
Current account balance estimate, pre-war	-250	-600	-600
"Downpayment," SUMED pipeline	-70	....	....
Extraordinary wartime costs	-45	-75	....
Savings from wartime austerity	100	....	....
Suez Canal dues	....	....	145
Other[1]	-60	60	....
Capital account	950	250	250
Khartoum aid	250	250	250
Extraordinary receipts	800	....	....
Extraordinary debt retirement[2]	-100	....	....
Change in reserves	625[3]	-365[4]	-205[4]

1. Payment for delivery of Australian and Canadian wheat in 1974.
2. Positively identified as of 1 December 1973.
3. Estimate as of 1 December 1973. Available during December for further debt retirement or expenditure.
4. Assuming little or no per capita income growth and no increase in foreign indebtedness.

The Economy Before the War

10. The present favorable financial position contrasts sharply with the deteriorating situation before the October war. Qadhafi, having become disillusioned with Sadat's pragmatic approach to economic and political problems, sharply curtailed Libyan aid to Egypt in 1972. This cutback, together with a decline in petroleum output, reduced Egyptian foreign exchange income by some $250 million in calendar year 1973. With no alternative sources of financing in sight and with prices of many essential commodities rising, Cairo was forced to cut back imports, depriving many industries of inputs and reducing the variety and quality of available consumer goods. By the fall of 1973, shopping queues had become a common sight in Egyptian cities, black market prices were soaring, and consumer grumbling was a serious embarrassment to the regime.

11. Sadat had few options at his disposal to cope with the potentially disastrous pre-war economic situation. Union with Libya had appeared to promise a renewal of economic aid, but Qadhafi was both stubborn and niggardly when he could not set the terms of the union. Sadat also sought additional financial support from the West, concluding debt rollover agreements with several creditor states and liberalizing regulations governing private investment in Egypt. Only West Germany, however, came forward with promises of substantial net aid. Egypt's socialist government was slow to implement liberalization measures, and private investors, frightened by threats of war and the prospect of union with the radical regime in Tripoli, demanded unacceptably stringent investment guarantees. Increased subsidy from the Saudi regime seemed a much less promising option at the outset, but in the end Faysal became the major external source of Egyptian subsidy. Faysal transferred at least $300 million to Egypt in late September 1973, reportedly with the foreknowledge that a war with Israel was imminent. The amount was sufficient to cover prospective Egyptian balance-of-payments deficits for a year or more. Faysal apparently refused, however, to guarantee the longer term subsidy that Egypt needed to implement development plans.

Prospects for the Economy

12. The financial cushion afforded by Arab aid almost certainly will forestall further economic decline. Moreover, if the military disengagement proceeds smoothly, permitting the Canal to reopen, Egypt should achieve some degree of economic recovery. The government probably could maintain per capita income at the 1972 level with an annual balance-of-payments deficit of about $350 million. Such a deficit could be covered until mid-1975 with cash now on hand, even if no further financial assistance were forthcoming. By that time an estimated minimum

$145 million in annual revenues from the reopened Suez canal will be available, substantially reducing the need for new aid.

13. If Egypt uses its funds judiciously, new lines of credit may be opened up. Cairo is actively exploring such a possibility, using cash to settle arrears which have stood in the way of loan negotiations. During November, private creditors in the United States and Europe were surprised to receive sizable payments against old accounts. Similar actions almost certainly would produce favorable results in Japan, where Arab oil pressures are producing a reassessment of relationships and where implementation of a credit rollover agreement awaits settlement of a number of overdue payments. A sizable prospective net flow of aid from West Germany also depends upon prompt payment of rescheduled debts. If Egypt were successful in improving its credit rating, financial resources and income could be augmented sufficiently to permit a modest amount of real per capita growth over the next two years.

14. Even with a reopened canal and some new lines of credit, Egypt will be hard put to finance its essential imports, much less any substantial development program, without foreign aid. The Egyptians will thus continue to depend, although less than before, on subsidies from the wealthy Arab states. The Khartoum agreement of 1967 provided that Saudi Arabia, Kuwait, and Libya would give to Egypt approximately $250 million annually in subsidies until "the effects of the [1967] aggression have been removed" – a condition generally interpreted to mean until the canal is reopened. This aid exceeds likely earnings from the Canal. Libya has already indicated that its $59 million share of Khartoum aid is to be discontinued primarily because Qadhafi is opposed to the disengagement. On the other hand, Saudi Arabia may wish to continue or even increase its annual aid in order to cement its greatly improved relations with Egypt, and Kuwait would then probably follow suit.

15. Disengagement also will permit Egypt to begin construction of the long-delayed SUMED (Suez to Mediterranean) pipeline. Completion of the first phase in about two and one-half years would provide about $25 million in additional foreign exchange revenues in 1976. By 1977, with both Phase I and Phase II in operation, net revenues should total about $100 million.

16. In the long term, the indirect impact of disengagement and, even more, of a general settlement in the Middle East could be far-reaching. By promptly reopening the canal and announcing a multi-million dollar canal expansion plan, Sadat would be reassuring the world of Egypt's peaceful intentions. The message is intended in part for Mrs. Meir, who has said that "if this aim actually begins to be achieved without delay, it can be

a highly significant turning point ... from war to the direction of peace." If peaceful conditions also permit Egypt's economic liberalization program, tentatively begun before the war, to be revived, there could be a substantial inflow of private Arab and Western capital.

17. Even if a sizable private capital inflow cannot be quickly generated, a general settlement could bring Egypt's long-term economic goals clearly within reach for the first time in a decade. Regaining Sinai would return to Egypt assets which have doubled in value. So long as oil prices hold, annual proceeds from the Sinai oilfields would total more than $300 million (see Table 3). This sum, plus canal revenues, SUMED pipeline revenues, and Khartoum aid, would close Egypt's payments gap and permit

Table 3

Selected Egyptian Balance-of-Payments Possibilities
1977

Million US $

	Constant Per Capita Incomes		Rising Per Capita Incomes	
	Disengagement	Settlement	Disengagement	Settlement
Current account balance	-355	-55	-555	-255
Pre-war estimate	-600	-600	-800	-800
Canal tolls	145	145	145	145
Pipeline revenues (net)	100	100	100	100
Sinai oil	....	300	....	300
Capital account				
Arab aid	250	250	250	250
Balance[1]	-105	195	-305	-5

1. A minus sign indicates a deficit to be financed by private capital or additional aid.

a 6%-7% annual economic growth. If peace were assured, the proposed inter-Arab investment bank, created to handle excess oil revenues, almost certainly would provide a sizable flow of funds to Egypt, as the Arab world's most advanced economy. Recourse to such a multilateral agency could replace Khartoum sibsidies and could also cancel much of the uncertainty and almost all of the political log-rolling formerly associated with Egypt's heavy dependence on bilateral aid.

18. Such a course of events also would loosen Egypt from its long, unhappy ties with the USSR. Little if any net Soviet economic aid has been received for several years, but Egypt has remained dependent on the USSR for military equipment as well as markets for surplus manufactured goods and lower grades of cotton. If peace and a substantial degree of prosperity were assured, Egypt would be less beholden to Soviet military aid and could afford to press for a westward orientation of production and trade. With Soviet economic leverage reduced, Egypt almost certainly would neglect its heavy military debt repayment obligations to the USSR, which could rise to as much as $200 million annually, until an acceptable rescheduling is arranged.